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Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

6 September 1983

Eastern Europe: Facing Up To The Debt Crisis

Summary

Most of Eastern Europe has withstood the severe credit crunch that began in 1980, but the region remains financially vulnerable. The peak of the crisis occurred in the first part of 1982, when it seemed that several countries were on the brink of default. The regimes responded by imposing austerity, mostly in the form of severe import reductions. With the incipient economic recovery in the West and signs of some easing in creditors' attitudes, the worst of the crisis is probably over. Some countries may yet have to reschedule their debts, however, and most will continue to look to the West for financial assistance. For the longer run, all will need to rely more on their own resources, which will increase pressure for more systemic solutions to economic problems. The adjustment process almost certainly will increase the risk of internal instability and will present problems and opportunities for the USSR and the West.

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The Credit Crunch

While Western bankers showed some unease about Eastern Europe as early as 1980, the credit crunch intensified the following year when Poland's inability to service its debts gave bankers second thoughts about continuing to lend to other East European countries (see Table 1). Banks initially refused to provide more medium-term loans. As a result, the East Europeans had to activate undisbursed credit lines, rely more on costly short-term borrowing, and draw down their reserves. By yearend, all the East European countries faced liquidity problems. The crunch thus hit Eastern Europe well before Latin America and other developing countries.

The squeeze grew particularly severe in the first half of 1982. The imposition of martial law in Poland and difficult rescheduling talks with Poland and Romania led bankers to withdraw short-term credits from the entire region in addition to refusing to roll over maturing medium-term loans. For the year as a whole, Western banks reduced their short-term exposure by 30 percent and rolled over only $3.6 billion of $9.1 billion in maturing medium and long-term obligations. Western government-backed credits did not offset the loss of private loans; the region as a whole contracted new government-backed loans in roughly the same amount that it owed in repayments (see Table 2).

Adjusting to the Credit Squeeze

Lack of credits and inability to expand exports because of Western recession forced the East Europeans to slash imports by 30 percent in 1981-82 (see Table 3). Planners focused the cuts on those items that would have the least immediate impact on their economies and populations. Purchases of capital equipment were generally denied because the loss of these items would not jeopardize current production. For political reasons, most regimes have been cautious about reducing purchases of consumer goods and foodstuffs although last year's good harvest permitted cutbacks in grain imports. Despite attempts at insulation, the reduction in Western imports has been a key factor in the slowdown of GNP growth which fell to 0.5 percent annually in 1980-82 for the six CEMA countries compared with an annual average growth of 2.5 percent in 1976-79. For Yugslavia, growth slowed from a peak of 7.0 percent in 1979 to only 0.3 percent last year.

The East European countries reacted to their financial problems in varying ways. Poland, after Western governments refused to reschedule its 1982 debt or extend new credits, secured de facto debt relief simply by not making repayments. Warsaw was able to negotiate debt relief from commercial banks,

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and [redacted] Warsaw met the repayment schedule. Altogether, Poland managed to cover less than half of its $11 billion financing requirement last year. The need to deal with the resulting arrearages continues to delay and complicate Warsaw's economic recovery. 25X1

Doubts about Bucharest's creditworthiness brought the credit crunch to Romania in early 1981. After arrears reached $1.1 billion at the end of the year, Bucharest gained breathing room through agreements with Western banks and governments to reschedule 1981 arrears and principal payments due in 1982. By mid-1982, there were signs that Bucharest was addressing its financial problems. By the end of the year it had cut imports by one-third, enough to earn a current account surplus of $655 million, but was still left with arrears of nearly $400 million. The import cuts intensified shortages of food, gasoline, and other consumer goods. Consumption fell for the first time since World War II and the rate of growth of industrial production fell to a new low.

The problems of Poland and Romania had a spillover impact on Hungary, East Germany, and Yugoslavia--countries also dependent on new credits to meet debt obligations. In Hungary, the withdrawal of $1.3 billion in short-term credits by Western, OPEC, and CEMA banks and inability to roll over medium-term credits brought Budapest to the brink of a liquidity crisis in early 1982. The Hungarians parlayed their good relations with the West and reputation as sound managers into enough emergency support from Western governments, the Bank for International Settlements (BIS) and the International Monetary Fund (IMF) to avert rescheduling. After temporizing for some months, Budapest imposed import controls and tougher austerity on consumers. Hungary consequently was able to slash its current account deficit by nearly $600 million and stabilize its financial position.

East Germany, despite suffering the region's largest cutback in credits--$1.9 billion, was the only heavily indebted country in the region that did not require debt relief or emergency loans in 1982. The East Germans apparently managed last year's credit crunch through tough adjustment measures and skillful cash management. Trade adjustments offset more than 80 percent of the cutback in bank credits, but the measures exacted a stiff price from the domestic economy. We estimate that GNP growth fell from 2.4 percent in 1981 to 0.5 percent last year.

Yugoslavia did not suffer as severe a reduction in Western bank lending as Hungary or East Germany, but the impact on its financial position proved more damaging. The country's financial crisis stemmed as much from failure to reduce the current account

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deficit and poor cash management in the banking system as from fewer credits. Belgrade's current account deficit reached $1.4 billion in 1982 instead of the planned $500 million and emergency measures to strengthen the Yugoslav National Bank's liquidity position failed. IMF credits of $600 million could not offset the shortfall in current earnings and capital flows, and Yugoslavia had to draw down its reserves by $1 billion. By year end, with arrears of $500 - $600 million, the country needed emergency financial assistance.

Because of their conservative trade and borrowing policies, Czechoslovakia and Bulgaria did not face as severe financial problems in 1982 as the other East European countries. The Czechoslovaks nonetheless slashed hard currency imports by 19 percent. The import curbs flowed from President Husak's pronouncement in 1981 that Czechoslovakia would not live on "credit". With shrinking export earnings, Prague's planners had to make deep cuts in purchases to meet the leadership's goal of reducing external indebtedness.

Bulgaria's low debt and comfortable maturity schedule freed it from onerous repayment obligations. Its conservative trade policy yielded surpluses on the hard currency trade account. Although some firms reported problems with payments from Sofia last year, we believe these were not the result of any serious financial deterioration.

Lender Attitudes

Lender attitudes toward Eastern Europe have eased slightly since last year's rush to reduce exposure, in part because their worst fears proved exaggerated. Poland did not default and Romania has improved its relations with banks. BIS and IMF involvement in Hungary's and Yugoslavia's crises has encouraged, and to some extent compelled, continuing banker involvement in these countries.

Continuing wariness among bankers and closer governmental supervision of commercial bank exposure will restrain the pace and extent of new loans. Major Eurodollar syndications will be much rarer than in the late 1970s; a far greater share of lending will be short-term and trade-related. The cost of credit will be higher, and the debt maturity structure will remain unfavorable for most countries. Commercial banks, furthermore, will likely insist on more Western government backing for their loans or demand security from the borrowers, including gold collateral and offsetting deposits.

As a prerequisite for increasing lending, bankers are looking for evidence that the East Europeans are addressing their

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payments imbalance through structural changes to improve export performance. Creditors regard the draconian import reductions of the past two years as a short-run expedient with little positive impact on long-term creditworthiness. Some bankers remain skeptical that the East Europeans will or can do as much as the financially troubled LDCs to correct their fundamental problems. To assure long-term economic discipline, they are putting more weight on IMF membership, while urging the East Europeans to provide more complete economic and financial data.

Outlook For 1983-85

In 1983, we estimate the region (excluding Poland, because of the uncertainties regarding rescheduling terms) will experience another large outflow on the capital account of nearly $2.8 billion. Yugoslavia will likely be the only net gainer, thanks to the Western financial rescue package. An expected slight improvement in borrowing conditions and a pickup in Western demand for East European exports should enable some East European countries to ease the severe import cuts of the past two years, but we still anticipate a decrease in the region's hard currency imports this year. Import gains seem likely in 1984-85, assuming continued growth in the West and continuing improvement in creditor attitudes. Only under the most favorable lending assumptions, however, would the absolute level of imports in 1985 exceed the level reached in 1980. With a modest revival of lending, imports in 1985 would be about 4 percent below the 1980 peak, while continued lending shortfalls would keep 1985 import levels some 8 percent below 1980 levels.

Even if lending revives, some countries--notably Bulgaria, Czechoslovakia, and Romania--may be unwilling to expand imports at the rates our projections suggest, opting instead to continue reducing hard currency debt or building up reserves. Most regimes will give preference to goods needed for consumption and current production. Some economists and planners, however, are arguing more strongly that their economies need a revival of investment, using Western resources to lay the foundation for long-term growth. This may have some greater impact down the road.

The prospect of slow export growth and at best small credit inflows means that financial problems will continue to beset nearly all the East European countries. In the near term, Poland--and very likely Yugoslavia--simply cannot generate enough debt servicing capacity on their own to meet obligations. Most regimes will have to restrain consumption and investment in order to lower demand for imports and free up goods for export. Pressure will build to produce more output with fewer inputs.

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This will point up the necessity of attacking the systemic flaws that contribute to low productivity.

Poland and Yugoslavia, caught in a medium to long-term financial crisis, seem least able to impose effective adjustment measures and to attack structural problems. Poland's insolvency and lack of progress in dealing with debt problems have locked it into a continuing economic crisis. Merely to stem the increase in its debt, Poland must generate net exports equal to annual interest payments, an effort requiring large current account surpluses and thereby a commitment by the regime to revive economic growth and by the populace to make large sacrifices.

Even with completion of this year's financial rescue package, we believe that Belgrade will need more help in 1984. Yugoslavia's position entering 1984 will be very similar to that at the beginning of this year--stock of imported goods and reserves will be at minimal levels and few credits will be in the pipeline to bridge the seasonal financing gap in the first half of the year. Adjustment policies and structural reforms needed for recovery may impose a higher price than regional politicians and the population are willing to accept.

Romania, East Germany, and Hungary show signs of financial recovery, but their positions remain fragile. East Berlin and Bucharest have squeezed their economies much harder than Budapest, while the latter seems farther along in addressing structural problems. Bucharest has passed the peak in its debt maturity structure, but is having problems in satisfying IMF targets and in obtaining credits. Even if it meets its goal of avoiding rescheduling next year, another test of its external adjustment efforts will come in 1985 when Bucharest must begin to repay obligations rescheduled in 1982. Next year's expiration of the current IMF standby arrangement also will add to pressures for large current account surpluses.

East Germany probably can avoid a rescheduling, but the country continues to face a serious liquidity problem. The recent decision of the West German government to guarantee a $400 million 5-year credit from West German commercial banks should improve prospects for covering this year's borrowing requirement. East Berlin can also draw on new government-guaranteed trade credits from France, Canada, and Austria. Over the medium term, the country will have to live more within its means, implement measures that improve export competitiveness, and promote economic growth without heavy reliance on Western imports and credit.

Hungary is still on a financial tightrope despite some successes in raising credits in the first half of 1983. Budapest

faces a rising level of debt repayments through 1985 and has requested a second IMF standby credit. The Hungarians must tighten adjustment policies, as well as continue to forge ahead with measures to improve efficiency and competitiveness. Fortunately for Budapest, many Western bankers believe they should support Hungary's reform program as an example for other East European countries.

Thanks to their small debts and generally good standing with Western banks, Czechoslovakia and Bulgaria enjoy the luxury of choosing whether to continue paying down their debt or to lift self-imposed restraints on imports from the West.

The Greater Implications

Our forecast of continuing serious financial problems for some countries (Poland and Yugoslavia) and, at best, slow improvement for the rest implies that the leaderships will face difficult decisions in the next few years. The problems are not new ones, but are now more severe than in the past. Muddling through--tinkering, temporizing, and relying on help from the USSR and the West--has become less of an option. More than ever, the East European countries will be forced to rely on their own resources and on the ability of their economic managers and systems to adjust. Continuing financial and related problems will influence East European policy on a wide range of issues:

- relations with the USSR, the West, and each other;
- allocation of resources to investment, consumption, and defense; and
- economic reform--along with its political and ideological implications. [redacted] 25X1

The East European regimes are likely to draw some sobering lessons from the financial crisis of the past two years and from the past decade of expanded economic ties with the West. While the Polish mess is abhorred by the rest of the region, most of the countries made some of the same mistakes, albeit to a lesser degree. In retrospect, the regimes overborrowed--at first to purchase Western capital goods with which to modernize their economies and later to buy grain and other supplies to support consumption. [redacted] 25X1

Although East European officials instinctively blame the West for their problems, they must also recognize that their own shortcomings made them more vulnerable to the credit cutoff. At a minimum, they probaby will try to be more certain that they can repay loans and will build more caution into their forecasts of

the potential impact of Western economic performance on their external accounts. At the same time, the East Europeans probably will conclude that they now need the West more than ever. The problems that led them to seek Western trade and credits a decade ago are now even more pressing.

Economic relations with the USSR will still figure heavily in their decision-making, and Bulgaria's relative economic success in recent years will stand as an example of the advantages of less dependence on the West and strong Soviet ties as well as, perhaps, increased CEMA integration. The leaderships realize that one of their chief assets is their borderline position between the USSR and the West and they will try to play off East against West.

The long-talked about CEMA summit, if and when it is held, should provide some clues as to which of these conflicting pulls is predominant. The USSR has been pressing for more balanced and possibly less subsidized trade, as well as for increased integration. The East Europeans have seen these aims as burdening their economies still more and threatening their relations with the West, and have delayed the convening of the summit.

The increased need for efficiency and the priority of boosting sales in hard currency markets is likely to give fresh impetus to reform advocacy in most countries. The problem is that reforms take a long time to implement and can be politically unsettling, threatening the privileges of the bureaucracies and challenging the ideological underpinnings of these regimes. The prospect of greater Soviet economic demands, continued stringency in economic relations with the West, and sharp domestic adjustments to the credit squeeze are likely to heighten tensions within the leaderships and between the leaderships and the led.

Although the populations have accepted recent austerity reasonably placidly, their patience may not survive the period of austerity ahead. The regimes will have to decide whether to use more repression (as in Romania) or to explain the problem and enlist public support (as in Hungary).

From the Soviet viewpoint, they will want to provide the minimum sustenance necessary to assure stability in Eastern Europe. With economic constraints of their own, the Soviets will want to avoid doing much more than is necessary.

East Europe's economic difficulties may also persuade Western governments that they have new opportunities to weaken Moscow's influence in the region. To pursue these opportunities, however, would require a revival of willingness to take financial

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risks and to use new policy tools, such as including more East European states in the IMF, and pursuing agreements between them and the EC or assuming politically motivated aid burdens of indefinite duration and return.

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NET FINANCING FLOWS FROM WESTERN BANKS[1]

(Million US$)

Table 1

	1975	1976	1977	1978	1979	1980	1981	1982	1983[1]
Eastern Europe	5,877	6,048	5,824	10,715	11,252	5,342	-1,513	-6,685	-2,122
Bulgaria	628	407	428	556	-86	-495	-489	-320	-170
Czechoslovakia	5	609	510	485	950	541	-224	-473	71
East Germany	1,164	1,170	715	1,494	1,760	1,375	805	-1,874	-389
Hungary	892	892	1,413	1,747	1,058	64	-305	-940	-457
Poland	2,427	2,550	1,327	3,167	3,393	339	-890	-1,373	-720
Romania	133	-163	470	1,406	1,552	1,362	-707	-826	-206
Yugoslavia	628	583	961	1,860	2,625	2,156	297	-879	-251

1 Net financing flows equal changes in the stock of bank claims [redacted] This reflects new credits less repayments.

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Table 2
EAST EUROPEAN DEBT 1971-1982
(Million US$)

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Eastern Europe												
Total	9,510	11,572	14,727	21,468	30,659	38,264	46,572	58,614	70,310	83,598	84,842	80,503
Commercial	5,396	7,243	9,828	15,634	23,721	29,667	36,388	46,952	55,904	61,793	59,692	53,383
Official	3,765	3,921	4,406	5,123	6,002	7,168	8,583	9,715	11,862	18,506	20,267	20,223
IMF/World Bank	349	408	493	711	936	1,429	1,601	1,948	2,544	3,299	4,883	6,897
Bulgaria												
Total	743	1,009	1,020	1,703	2,640	3,198	3,707	4,263	4,032	3,562	3,065	2,782
Commercial	442	765	818	1,520	2,453	2,878	3,394	3,935	3,619	3,128	2,575	2,187
Official	301	244	202	183	187	320	313	328	413	434	490	595
Czechoslovakia												
Total	485	630	757	1,048	1,132	1,862	2,616	3,206	4,096	4,756	4,400	3,998
Commercial	284	435	558	821	926	1,575	2,290	2,798	3,502	4.013	3,610	3,158
Official	201	195	199	227	206	287	326	408	594	743	790	840
GDR												
Total	1,408	1,554	2,136	3,136	5,388	6,292	7,828	9,666	12,312	14,089	14,680	13,077
Commercial	693	771	1,348	2,243	4,423	5,217	6,528	8,166	10,225	11,411	11,535	9,642
Official	715	783	788	893	965	1,075	1,300	1,500	2,087	2,678	3,145	3,435
Hungary												
Total	1,071	1,372	1,442	2,129	3,135	4,049	5,024	7,290	8,140	9,276	8,700	7,800
Commercial	968	1,274	1,353	2,053	3,081	3,998	4,965	7,197	8,008	9,053	8,380	6,748
Official	103	98	89	76	54	51	59	93	132	223	320	415
BIS/IMF												637
Poland												
Total	1,399	1,825	3,057	5,313	8,879	12,307	14,621	17,600	21,100	24,840	25,500	24,800
Commercial	420	856	1,951	3,586	6,547	9,159	10,393	12,532	15,300	14,740	15,045	14,340
Official	979	969	1,106	1,727	2,332	3,148	4,228	5,068	5,800	10,100	10,455	10,460

Table 2 (cont'd)

Romania												
Total	1,227	1,249	1,611	2,693	2,924	2,903	3,605	5,221	6,950	9,467	10,160	9,766
Commercial	585	597	682	1,780	2,024	1,841	2,306	3,609	5,100	6,537	6,167	5,408
Official	642	652	814	797	706	659	715	800	905	1,750	1,845	1,428
IMF/World Bank/ CEMA banks	0	0	115	116	194	402	584	812	945	1,180	2,148	2,930
Yugoslavia												
Total	3,177	3,933	4,704	5,446	6,561	7,653	9,171	11,369	13,680	17,608	18,337	18,280
Commercial	2,004	2,525	3,118	3,631	4,267	4,999	6,512	8,715	10,150	12,911	12,380	11,900
Official	824	1,000	1,208	1,220	1,552	1,628	1,642	1,518	1,931	2,578	3,222	3,050
IMF/World Bank	349	408	378	595	742	1,026	1,017	1,136	1,599	2,119	2,735	3,330

* Includes Western government-guaranteed credits and direct official loans.

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Table 3
Eastern Europe: Hard Currency Trade
(Million US $)

	1972	1975	1980	1981	1982
Exports--Total	8853	17828	38761	37912	37086
Bulgaria	509	1190	3021	3198	3292
Czechoslovakia	1382	2378	4528	4691	4029
East Germany	1642	3052	6565	6714	7148
Hungary	994	1691	4911	4860	4885
Poland	1796	4123	7506	5448	5639
Romania	1148	2839	6574	7281	6235
Yugoslavia	1372	2555	5656	5720	5858
Imports--Total	10551	27167	46890	41154	34401
Bulgaria	520	1489	2035	2546	2572
Czechoslovakia	1366	3145	4178	4450	3537
East Germany	2125	4178	8145	6654	5663
Hungary	1078	2464	4632	4417	4108
Poland	2067	6796	8488	5422	4174
Romania	1265	2950	8091	7065	4710
Yugoslavia	2130	6145	11321	10600	9637
Balance--Total	-1689	-9339	-8129	-3242	2685
Bulgaria	-11	-299	986	652	720
Czechoslovakia	16	-767	350	241	492
East Germany	-483	-1126	-1580	60	1485
Hungary	84	-773	279	443	777
Poland	-271	-2673	-982	26	1465
Romania	-117	-111	-1517	216	1525
Yugoslavia	-758	-3590	-5665	-4880	-3779